

# THE CONTINUING NEED FOR BROKER-DEALER PROFESSIONALISM IN IPOs

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*In this essay, I contend that the IPO process and its abuses of the late 1990s reveal a fundamental problem in the brokerage industry. The abuses reveal the culmination of a concerted training in business, business schools, and even law schools and, more generally, in society: the acceptance of self-interested profit maximization as the sole goal for business and financial activities. I first review the IPO abuses from the perspective of individual self-interest and the group enhancement of it to show the fundamental motivation of the abuses. I then examine the regulatory responses to these abuses in order to point out their incompleteness. I argue that the reforms were incomplete because they established limited broker-dealer professionalism, focusing only on research analysts, which perversely encouraged those not directly touched to continue to engage in self-interested conduct. I also contend that this absence of full broker-dealer professionalism can lead to reputational risk that threatens these financial institutions and even the stability of the securities markets. I thus suggest that the professional reform for broker-dealers must be wide-ranging and must reach into the training of future bankers and brokers in the business schools. However, I also offer a practical, stopgap reform suggestion that can help alleviate reputational risk.*

## I. INTRODUCTION: IPO ABUSES AND BROKER-DEALERS

There were abuses in the initial public offering (“IPO”) process by broker-dealers, and they occurred particularly during the late 1990s before the bursting of the NASDAQ “bubble.” The abuses were often based upon the underpricing of IPOs. IPO underpricing is a longstanding phenomenon, which was exacerbated during the bubble years.<sup>1</sup> It means that an IPO is

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<sup>1</sup> See Peter Oh, *The Dutch Auction Myth*, 42 WAKE FOREST L. REV. 853 (2007) (pointing out that underpricing was particularly significant during the last years of the bubble). See *id.* at 15 (citing finance data). In reviewing the finance literature on

often priced at a considerable discount to its “true” value, which is understood to be represented by its closing price on its first day of trading. If there is underpricing, anyone who receives an allotment of IPO shares obtains a considerable, even spectacular, gain in the first hours or days of trading. As is well known, during the IPO bubble certain abuses based on this underpricing occurred. IPO shares were allotted to favored investors, often executives with whom a broker-dealer wanted to do business, in a practice known as “spinning.” In return for an allotment, investors were asked to purchase other offered securities in the aftermarket to ensure the offering’s success (known as “laddering”), or to return profits to the broker-dealer firms through excessive commissions on other trades. Sell-side analysts (that is, those working for broker-dealers rather than for investors) were urged and rewarded to promote an IPO by promising to support later the subsequent trading in the shares of the IPO company through the issuance of favorable research reports. The abuses were exacerbated in the bubble environment fostered by the Internet, which facilitated the diffusion of information about the IPO companies (often themselves companies with Internet-based business) and individual stock trading. As is also well known, many of these abuses were specifically addressed through changes to rules of the Securities and Exchange Commission (“SEC”) and self-regulatory organizations (“SROs”), as a result of the Global Settlement with investment banks, and because of the Sarbanes-Oxley legislation.

An important question is whether these IPO abuses, so exacerbated in the bubble, were an aberration in an otherwise properly functioning process, or something more. How one answers this question, I suspect, determines one’s approach to the IPO abuses. It certainly makes sense to assume, as some do on the basis of the performance of the U.S. economy and its capital markets and of a belief in the inherent strengths of the market system, that the IPO process is basically a rational and well-functioning method of raising and allocating capital. Since it is a human process, there are always imperfections that need to be addressed, and one can make a strong case that they should be identified by empirical examination, not simply by anecdotal evidence cited by the media and politicians. This is the approach of many financial economists, legal and financial practitioners, and regulators, such as the New York Stock Exchange/NASDAQ (“NYSE/NASD”) IPO Advisory Committee.<sup>2</sup> Proponents of this position

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underpricing and underwriter activity in IPOs, Professor Peter Oh cautions against simplistic explanations, pointing out that there are rational explanations for the phenomenon, e.g., underwriters underprice because they need to guarantee the success of the offering, to minimize their liability under Section 11 of the Securities Act, and to compensate institutional investors who provide them with pricing information and repeat customers.

<sup>2</sup> NYSE/NASD IPO ADVISORY COMMITTEE, REPORT AND RECOMMENDATIONS OF A COMMITTEE CONVENED BY THE NEW YORK STOCK EXCHANGE, INC. AND NASD AT THE

would assert that after the IPO abuses, and particularly given advances in information technology (especially the Internet), there is no reason to go back to business as usual with broker-dealers.<sup>3</sup> The appeal of this position is that it does not regard the status quo in IPOs as a good state of affairs, since on this view broker-dealers use the current practice of price determination to benefit themselves at the expense of companies and certain (generally retail) investors.<sup>4</sup>

My concern with the IPO abuses is somewhat different from the above perspectives and is similar to my approach to the major corporate scandals of 2001-2002.<sup>5</sup> I contend that the IPO process and its abuses reveal a fundamental problem in the brokerage industry.<sup>6</sup> I argue that the abuses reveal the culmination of a concerted training in business, business schools, law schools, and in society generally: the acceptance of self-interested profit maximization as the goal for business and financial activities.<sup>7</sup> I argue that, at a moment in time, through a confluence of circumstances, this training came to fruition in a setting where its

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REQUEST OF THE U.S. SECURITIES AND EXCHANGE COMMISSION 3 (May 2003)  
[hereinafter NYSE/NASD IPO ADVISORY COMMITTEE].

<sup>3</sup> See, e.g., Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 787-90 (2005).

<sup>4</sup> But see Ravi Jagannathan & Ann Sherman, *Why Do IPO Auctions Fail?* (Oct. 15, 2006), available at <http://www.ssrn.com/abstract=874344> (for a defense of the traditional U.S. method of broker-dealer involvement in and pricing of IPOs, known as bookbuilding). In bookbuilding, the managing underwriter shops the IPO to favored investors, usually institutional investors, to solicit their interest in the offering and from the expressions of interest determines the offering price. Their argument is that the other main method of determining the IPO price, through an auction, does not work, because there is too much uncertainty in the process (i.e., in the number and sophistication of potential investors). They argue that bookbuilding is necessary because it identifies sophisticated investors and compensates them for their willingness to invest in a relatively new company and because it effectively removes unsophisticated investors, who only “free ride” on the sophisticated, from the process. See also François Derrien & Ambrus Kecskés, *The Initial Public Offering of Listed Firms*, 62 J. FIN. 447 (2007) (for an interesting suggestion about another IPO alternative from U.K. practice, which involves a listing of a firm’s shares and then a subsequent IPO).

<sup>5</sup> James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435 (2004).

<sup>6</sup> See NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 2, at 4 (indicating from the bubble years a systematic problem in the IPO process).

<sup>7</sup> See, e.g., Herbert Gintis & Rakesh Khurana, *Corporate Honesty and Business Education: A Behavioral Model 2* (June 29, 2006), available at <http://www.ssrn.com/abstract=929173> (“Neoclassical economic theory thus creates a corporate atmosphere that legitimizes a culture of greed in which managers are encouraged to care about nothing but personal gain, and in which such character virtues as honesty, trustworthiness, and fairness are deployed only contingently in the interests of personal material reward.”).

participants, particularly, although not exclusively, investment bankers and broker-dealers, had considerable professional discretion in the IPO process. The discretion, which may make sense in pricing IPOs in a situation of less than complete information about the value of the IPO company, was used by the participants to enrich themselves, without professional, moral, or other norms to restrain them.<sup>8</sup> That is, the participants came to believe that only the material consequences to themselves and their colleagues, and perhaps to their families, mattered, and they had little regard for their organizations, the marketplace, and the economy.<sup>9</sup> Public outrage and legal and market reforms ensued, but in time the abuses have been forgotten and the reforms have been scaled back or not implemented. My concern is that, if something fundamentally has changed in the “world view” of financial participants, it is a mistake to return to business as usual, or even to reform the IPO process only in a technocratic way, for the abuses are likely to recur, albeit in a different form.

Indeed, I would even caution against focusing too much on, or giving exclusive attention to, IPO abuses, for the important point is that unrestrained self-interest may break out elsewhere in the future, or is breaking out elsewhere in the financial industry now. It sounds almost quaint today to discuss IPO abuses when the current financial abuses may involve the financial engineering used in buying and reselling companies, which may include an IPO, but where the abuses may involve low-priced purchases of public companies, management participation in buyouts, subsequent draining of assets from the firms, and then IPOs of weak firms.<sup>10</sup> Wall Street, which consists of, among others, some of the best college graduates who have been trained based on self-interested profit maximization, can be highly inventive in benefiting its participants.

My basic concern connects indirectly to the purpose of this symposium, which is the promotion of entrepreneurial activity through the Internet, including using the Internet for IPOs. I am concerned that the

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<sup>8</sup> Cf. NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 2, at 19 (recognizing the importance of professional obligations insofar as the committee recommends an enhancement to professional behavior of investment banking teams involved in IPOs and more emphasis upon it in broker-dealer examinations).

<sup>9</sup> See Gintis & Khurana *supra* note 9, at 21 (“[B]y abjuring professional standards for managers in favor of a culture of greed, it is likely that business schools that have promoted the neoclassical model of stockholder-manager relations have so undercut the culture of professional honor among managerial personnel that the mechanism of informal third-party punishment and reward has sunk to dramatically low levels, thus contributing to a deficit in moral behavior on the part of contemporary managerial personnel.”).

<sup>10</sup> See Jerry Cao & Josh Lerner, *The Performance of Reverse Leveraged Buyouts* (Oct. 15, 2006), available at <http://www.ssrn.com/abstract=937801> (presenting criticisms of the current “going private” wave, but finding that the performance of firms subject to a Leveraged Buy-Out (“LBO”) and then taken public was better than comparable firms doing IPOs).

dominance of unrestrained self-interest, together with investor losses, may have consequences that are difficult to measure, but which may be significant: there are large profits for the financial industry, but also the creation of a generation of investors suspicious of the securities markets and investment in public companies despite the ease, made possible by the Internet, of investing in these companies' IPOs. This consequence perversely reaffirms the self-interest perspective even in those harmed by it, in much the same way that children are told to take before someone takes from them. As an analogy, it is like global warming, which has also been produced by short-term human self-interest: the consequences of an excessive self-interested short-term focus are ignored, but then appear rapidly with extremely destructive force.<sup>11</sup> To respond to this self-interest phenomenon and its effects will thus take more than technical adjustments to the IPO process, although I shall try to offer one concrete proposal in Section IV.

The essay is structured as follows: in Section II I review the IPO abuses from the perspective of individual self-interest and the group enhancement of it to show the fundamental motivation of the abuses; I then examine the regulatory responses to these abuses in Section III. My intention there is not to comprehensively review the reforms, but to point out their incompleteness and to set the stage for my basic argument. This argument comes in Section IV, where I argue that the reforms were incomplete because they established only limited broker-dealer professionalism, focusing only on research analysts, which perversely encouraged those not directly touched to continue to engage in self-interested conduct. I also contend in Section IV that this absence of full broker-dealer professionalism can lead to reputational risk that threatens these financial institutions and even the stability of the securities markets. I suggest that the professional reform for broker-dealers must be wide-ranging and must reach into the training of future bankers and brokers in the business schools. However, I also offer a practical, stopgap reform suggestion that can help alleviate reputational risk. I conclude in Section V.

## II. THE CENTRALITY OF INDIVIDUAL AND GROUP SELF- INTEREST IN THE IPO ABUSES

In this section, I argue that the IPO abuses were understandable if one considers that the IPO participants were motivated primarily by individual and group self-interest (narrowly defined as the promotion of the welfare of each group member). In other words, the abuses were "over-determined" by self-interest and enhanced by group processes and motivations. The individual and group motivations were so powerful that,

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<sup>11</sup> See EDWARD O. WILSON, *THE FUTURE OF LIFE* 42-78 (2002).

once activated, they created a bandwagon effect for completion of the IPO and for participation in the abuses. Here, I review the self-interest of each of the participants and the group enhancement below to emphasize how powerful they are, and thus how difficult it is for social and organizational processes to counteract them. Moreover, I argue that because of the centrality of the broker-dealer in the IPO, the self-interested conduct of the bankers, analysts, and brokers working for the broker-dealer sends a message to the other IPO participants that this is the acceptable behavioral norm for the process.

Let me summarily review the IPO process from the perspective of the self-interest of each of its participants. I contend that both their training and the financial culture guide their conduct on the basis of self-interest.<sup>12</sup> The executives and the directors of an IPO company (also known as an “issuer” of the securities) want the IPO for all kinds of justifiable reasons that financial economists have long explored and documented. For example, the IPO signals that in a competitive market the firm is moving to the next stage of its development, and the IPO gives the firm competitive advantages, such as funds to make significant investments and public stock as acquisition currency.<sup>13</sup> Naturally, the self-interest of directors and officers is also tied up with the IPO’s success. They would individually value the possibility of cashing out their shares either in the IPO or into a secondary securities market that is created following a successful IPO. This latter sale is available to them once the lockup expires.<sup>14</sup> This may be a

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<sup>12</sup> These self-interest motivations are spelled out at length in “insider” views of financial services. See, e.g., PHILIP AUGAR, *THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME* (2005).

<sup>13</sup> See Jagannathan & Sherman, *supra* note 4, at 13 (emphasizing that executives have many reasons for IPOs and that obtaining the most proceeds is not their highest priority; rather, executives care about the success of the IPO for the long-term success of the firm, which means gaining an analyst following and institutional investors as buyers). For a survey of the literature on why companies conduct IPOs, see Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1796-1800 (2002). For a recent article surveying the views of CFOs regarding the IPO process, see James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399, 400 (2006) (finding that CFOs do an IPO primarily to create public shares for acquisitions, that they select underwriters based on reputation, research, and expertise, and that they feel underpricing is a cost of business to compensate investors for risks). See also Sreedhar T. Bharath & Amy K. Dittmar, *To Be or Not to Be (Public)* (Dec. 2006 draft), available at <http://www.ssrn.com/abstract=951710> (finding that information and liquidity concerns are the strongest factors in the decision to go and to remain public).

<sup>14</sup> Generally, underwriters insist that officers and directors not sell their shares of the company immediately after a public offering, for such sales would put selling pressure on the aftermarket price and send a negative signal to the market. Accordingly, insiders’ shares are subject to a contractual “lock-up” of typically 180 days following the offering. Cf. Alexander Ljungqvist & William J. Wilhelm, Jr., *Does Prospect Theory Explain IPO Market Behavior?* (2004 draft), available at

“once in a lifetime” opportunity for their enrichment. Moreover, although the executives might not benefit from the IPO at the offering, their “friends of the family” who receive allotments would, which could provide additional satisfaction to the executives.<sup>15</sup> In addition, investment banks typically promise executives and directors benefits following the offering, such as shares in other hot IPOs, hedging services to protect their continuing investment in the firm, and a high stock price through positive research reports for their stock sales after the expiration of the lock-up.

The executives are of course not straw men and women; reasons and emotions complement and even restrain their self-interest. For example, they may be concerned that the company is proceeding too fast out of the private capital market, and thus that the IPO may put the company and its executives and directors in a precarious position if it does not work out. There will likely be a reservation price below which they will not do the offering. But the pressure to succeed in highly competitive product markets, coupled with their self-interest, especially if it is constantly appealed to by investment bankers (and media frenzy), may be too great for the executives and directors to resist. Once they are committed to a transaction, they will likely not be put off.

Existing shareholders of an IPO firm, particularly the venture capital firms, also have a powerful self-interest to do the IPO, since they would value the opportunity, at the time of the IPO or subsequently, to sell off their stake in the firm. The main reason, in fact, for the investment of many of these private investors in private companies is to profit from a sale of the firm, preferably into the public markets, as this produces the greatest returns to them.<sup>16</sup> Since venture firms are repeat players, from a self-interest perspective they have reputational reasons to be careful about being too self-interested in the IPO process. A venture capital firm would like to be known as an investor in companies that are successful in the public

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<http://www.ssrn.com/abstract=571007> (explaining how IPO executives “anchor” on the midrange price offered by the investment bankers, who give a range of the likely sales price for the IPO, and then calculate how much they lost or gained in the IPO with respect to their locked-up shares).

<sup>15</sup> Professor Christine Hurt discusses these motivations for executives and directors. See Christine Hurt, *What Google Can't Tell Us About Internet Auctions (and What it Can)*, 37 U. TOL. L. REV. 403, 409-10 (2006). “Friends of the family” or directed share programs (“DSPs”) are programs that allocate a portion of the offering to certain groups, typically employees, directors, and sometimes officers, customers, and suppliers of the issuer. These programs can be large (although there is no typical size). It has been found that officer and director participation in DSPs does not result in more underpricing, and that reputable underwriters discourage the use of such programs in offerings. See generally Rina Ray, *Directed Share Programs in IPO Underwriting and Agency Problems* (Dec. 1, 2006), available at <http://www.ssrn.com/abstract=921675>.

<sup>16</sup> See INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 38 (Nov. 30, 2006) [hereinafter COMMITTEE ON CAPITAL MARKETS REGULATION].

securities markets, and it would thus prefer to bring to market only high quality firms (not “lemons”). Indeed, there is evidence that venture capital-backed IPO firms were subject to fewer IPO abuses (i.e., they had less underpricing), which might show that venture firms are more rational in the IPO process and check their self-interest.<sup>17</sup> However, the lack of survival of a venture capital-backed IPO company may not be immediate and, thus, may not harm the reputation of the sponsoring venture capital firm. This assumes that investors have short memories, the investor community changes, and that the investors who matter (institutional investors) are not hurt, because these institutions benefit from an IPO despite the IPO company’s later failure (i.e., they resell IPO shares soon into the aftermarket).<sup>18</sup>

The broker-dealer firms (i.e., the investment banks) are the main gatekeepers to the public securities markets for IPO firms,<sup>19</sup> and they are my primary concern here. Not only did they engineer many of the IPO abuses (just as they participated in the abuses in the corporate scandals), but their behavior sent a signal to all the IPO participants (as well as to the public) that self-interest was the order of the day. Not surprisingly, the self-interest of the broker-dealer firms, their principals, and their employees motivates them to find and to complete these transactions.<sup>20</sup> An IPO represents for the firm not only the fees for the transaction, which is the IPO discount or difference between the investment bank’s price paid for purchasing the securities from the company and the price at which it resells them to the public, but also the promise of future business from the

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<sup>17</sup> See generally C.N.V. Krishnan et al., *Does Venture Capital Reputation Affect Subsequent IPO Performance?* (Oct. 31, 2006 draft), available at <http://ssrn.com/abstract=910982> (presenting data showing that IPO companies backed by the most reputable venture capital firms (defined in terms of a firm’s share of venture capital-backed IPOs)—have the best long-term performance of IPOs).

<sup>18</sup> Venture capitalists can also receive side-benefits from the bankers, for they, too, are allocated shares of hot IPOs. See Jonathan Reuter, *Are IPO Allocations for Sale? Evidence From Mutual Funds*, 61 J. FIN. 2289, 2323 (2006).

<sup>19</sup> See Jagannathan & Sherman, *supra* note 4, at 36 (pointing out that an underwriter in bookbuilding screens for knowledgeable investors and companies with potential, thus ensuring the success of a process that is filled with uncertainty).

<sup>20</sup> Some have cautioned about making blanket assumptions that broker-dealers are self-interested to the point of being exploitative. In a survey of conflicts of interest in financial institutions, Professor Rene Stulz and his co-authors find that the financial economic evidence does not necessarily support the view that broker-dealers exploited their customers, even in the bubble. See Rene Stulz et al., *The Economics of Conflicts of Interest in Financial Institutions* (Fisher College of Business Working Paper Series, No. 2006-03-005, Nov. 30, 2006), available at <http://www.cob.ohio-state.edu/fin/dice/papers/2006/2006-21.pdf>. Moreover, the authors of this study contend that some evidence (e.g., analysts keeping their ratings after an IPO, when the stock has fallen in price) may in fact reflect not self-interest, but behavioral biases (e.g., over-optimism by the analysts and a refusal by them to admit that their valuation models are wrong).



company to the bank, such as follow-on offerings, mergers and acquisition transactions, asset management and risk protection for executives and major shareholders,<sup>21</sup> market making and commission income from trading, and other proprietary trading activities. Even if an IPO firm proves to be unsuccessful, the broker-dealer can profit from it before its ultimate demise. As in the case of venture capital firms, the broker-dealer must be concerned about its investors and the negative consequences of promoting firms that eventually fail. But, as discussed below, it may be able to please the investors who matter (such as those who receive allocations in “hot” offerings, and the hedge funds that benefit from market fluctuations) and may be indifferent to retail investors (who come and go, who are often relegated to centralized services from broker-dealers, and who are little more than a source of commission and fee income), and its trading profits with respect to the company may outweigh any loss of business due to the dissatisfaction of (again, largely retail) investors.<sup>22</sup> Moreover, as shown by the late 1990s bubble, broker-dealers had various methods (many now banned) of profiting from IPOs: requiring large investors to purchase shares in the aftermarket in order to receive an IPO allotment, to direct commissions to brokers on other trades (often at high rates), or to purchase shares of “bad” IPOs in return for receiving an allotment in a “good” one.<sup>23</sup>

Significantly, the individual investment bankers that look for and execute IPO transactions have a strong self-interest in obtaining IPO mandates and completing them. Their bonuses are determined by the amount of business that they generate and complete; they generally do not have to worry about the consequences of an IPO company that later fails since they may no longer even work for that broker-dealer. In short, their incentive is to do the deal and to move on to the next. Perhaps the best example of this kind of motivation was Frank Quattrone and the members of his former group with Credit Suisse.<sup>24</sup> They were valued for the stream of transactions that they could bring into any broker-dealer that would agree to house them. In a similar way, sell-side analysts working for broker-dealers had the same motivations as the bankers to promote the IPOs,

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<sup>21</sup> For example, the NYSE/NASD IPO Advisory Committee observed that underwriters provide issuer executives and others subject to lockups with derivative contracts to lock-in “virtual” IPO gains that they may have. See NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 2, at 17.

<sup>22</sup> For a survey of why underwriters rationally underprice and how underwriters benefit from IPO allocations, underpricing, and follow-on work, see Ritter & Welch, *supra* note 13, at 1808-15.

<sup>23</sup> See *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 27 (2d Cir. 2006); NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 2, at 1-2.

<sup>24</sup> Some background on Quattrone is provided in *United States v. Quattrone*, 441 F.3d 153 (2d Cir. 2006) (overturning his criminal conviction). For a critical view on the current culture of investment bankers, see JONATHAN A. KNEE, THE ACCIDENTAL INVESTMENT BANKER 171-87 (2006).

particularly when they were compensated in a similar manner.<sup>25</sup> The management of investment banks (with a longer term perspective on profitability than the individual bankers) showed little effort to restrain banker teams during the abuses, since they wanted to retain these good producers and, like others in the firm, they shared in the profitability of the IPOs.

Furthermore, certain investors had self-interested reasons for investing in IPOs. They may invest in IPO securities, provided that they can sell their shares at a significant profit into the market (or, of course, find a profitable long-term IPO investment).<sup>26</sup> These are the investors, typically institutional investors, favored by the broker-dealer firms,<sup>27</sup> who were invited to the oral roadshows and profited from IPO underpricing, even if they had to share their profits with broker-dealers.<sup>28</sup> These are generally the money managers, whose relationships with broker-dealer firms are complex: purchasing IPO shares is only one part.<sup>29</sup> Again, these investors

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<sup>25</sup> This remark about the motivations of analysts echoes Professor Coffee's analysis of them and other individual professionals in his book on "gatekeepers," where he emphasizes that scandals often arose because the relationship banker, analyst, auditor, or lawyer was motivated by self-interest only to complete transactions in order to please the client and received little oversight from the supervisors in his or her firm. See JOHN C. COFFEE, *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 245-82 (2006). Regulation AC now bans the tying of analyst compensation to investment banking success (yet their compensation remains connected to the firm's profitability). See *infra*. See also François Derrien, *Currying Favor to Win IPO Mandates* (Dec. 5, 2006), available at <http://ssrn.com/abstract=888204> (finding that favorable analyst coverage of an IPO managed by another bank increases the chance that the analyst's firm will be a co-manager in the next IPO managed by that bank, provided that both banks are high status (which suggests that conflicts affect analysts with respect to offerings of banks other than their own), and that positive coverage of the firm's own managed IPOs increases the chance of receiving other IPO mandates, but this finding applies only to less prestigious banks).

<sup>26</sup> See Francesca Cornelli et al., *Investor Sentiment and Pre-IPO Markets*, 61 J. FIN. 1187, 1188-89 (2006) (contending that sophisticated institutional investors who receive IPO allotments take advantage of the over-optimism of retail investors and smaller institutions in reselling the IPO shares).

<sup>27</sup> In other words, these are the institutional investors who do the most business with broker-dealers, rewarding them with the highest commissions and fees. See Reuter, *supra* note 20, at 2291 (finding that mutual funds that received hot IPOs did more business with allocating broker-dealers than those funds that did not receive the IPOs).

<sup>28</sup> Or (which is not exclusive of the first account) these may be rational arbitrageurs who try to anticipate public sentiments in investing, rather than trying to "discipline" the public through short selling. See ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* 154-156 (2000).

<sup>29</sup> On this point, one thinks of the soft dollar arrangements broker-dealers offer to money managers and the services (not always legal) money managers provide to broker-dealers (making indirect payments to broker-dealers in return for their directing clients to the products of the money manager). See generally 1 NORMAN S. POSER & JAMES A. FANTO, *BROKER-DEALER LAW AND REGULATION* § 10-42 to § 10-67 (4<sup>th</sup> ed. 2007).

must be contrasted with retail investors, who do not generally receive IPO allotments (except for IPOs that are in trouble), but who can purchase the IPO securities in the aftermarket, often in the speculative frenzy facilitated by the ease of trading made possible by the Internet.

Under this account, the self-interest incentive structure of all the parties (exacerbated by the broker-dealer as a kind of master of ceremonies of the IPO) led to the IPO abuses. With self-interest acting as a baseline motivation for the executives, the bankers, and others involved, group motivations exacerbated the IPO abuses.<sup>30</sup> I suggest that, as in almost all human activity, the participants in the IPO form a group or “team” to accomplish the transaction. Group processes and motivations reinforce and magnify the individual motivations discussed above. Most significantly, since all participants are motivated by self-interest to complete the IPO, the group has a reason for forming and a readily provided justification for its existence (i.e., that each participant will benefit greatly from this transaction). Moreover, since the broker-dealer is at the center, and its bankers are arguably the leaders of the groups and subgroups that form in the IPO process, and since they are enhancing by their own example the message of self-interest in the transaction, the groups become powerfully cohesive.

In my view, the IPO abuses thus owed much to the formation and strength of the deal groups or teams. If an IPO only involved disparate individuals separately working for its completion, there would be more of a chance that abuses would not have occurred. For example, if one participant’s motivations other than self-interest became stronger than the self-interest, he or she might question the process. A deal group, however, created a dynamic because it gives its participants a social identity, even if one limited by the transaction, that makes it very difficult for a participant not to go along with practices that are endorsed by the group and particularly by its leaders (the practices are endorsed simply because “that is the way things are done”). I refer here to the well-known characteristics of groups (particularly cohesive groups with a specified mission) to discourage (and to punish) dissent among their members and to create a form of self-censorship whereby the group member accepts the group’s

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<sup>30</sup> One could also assert that “quasi-rational” motivations also animated the participants. These kinds of motivations are now fairly well-known and set forth in the behavioral law and economics literature. They are essentially ways of thinking that are not entirely rational, which strongly affect an individual’s decision-making. To take only one example: individual executives and bankers are likely to be overly optimistic that their IPO will be particularly successful and will have results identical to those of well-known IPOs, which are visible and well publicized, rather than the result of unsuccessful IPOs, which are, in any case, not emphasized in the bubble environment. See generally HERSH SHEFRIN, *BEHAVIORAL CORPORATE FINANCE: DECISIONS THAT CREATE VALUE* 1-9 (2007).

views, even if he or she knows them to be false or dishonest (this is often referred to as “groupthink”).<sup>31</sup> These characteristics can lead individuals in groups to participate in, often incrementally, or at least to turn a blind eye to, what can be characterized as clearly improper and illegal practices (in the IPO case, laddering and spinning). Groups can also exaggerate the baseline motivation of their members (i.e., in this case, make participants even more self-interested). I recognize that deal teams are transient and do not mean to suggest that participants are completely captured by them. But it would be a mistake to ignore their power, particularly if group goals reinforce the motivations of members and the purposes of other groups to which they belong.

### III. SEC AND SRO PROPOSALS AND SOLUTIONS TO THE ABUSES

If one accepts the above account of an individual and social reality that contributed to the IPO abuses and that can lead to new ones, it is necessary to ask how to counter the self-interest of the participants, and the group enhancement of it orchestrated by broker-dealers. It is certainly old news that the SEC and the SROs, sometimes directed by Congress, did what one expects from those in the real world: they addressed specific IPO abuses by regulating the conduct of broker-dealers in the IPO process. The current news or debate is whether, in this pragmatic regulation, Congress and the regulators “over-regulated,” for example, by addressing non-existent abuses or imposing regulations the costs of which surpassed the harm arising from the abuses.<sup>32</sup> I review below several responses to the IPO abuses and suggest that, for the understandable reason that the reforms had a pragmatic focus, they did not address the underlying problem.

As is well known, the SROs, rather than the SEC, primarily addressed the IPO abuses. The SRO reforms to the IPO process had several origins: the findings of the NYSE/NASD IPO Advisory Committee, the Global Settlement regarding securities analysts,<sup>33</sup> and eventually the Sarbanes-Oxley Act of 2002.<sup>34</sup> Many of the recommendations of the NYSE/NASD IPO Advisory Committee were technical and dealt with specific abuses. Significantly, it recommended that a broker-dealer should be prohibited from “spinning” shares to officers and directors of investment banking clients, prospective clients, and money managers, as well as to

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<sup>31</sup> See generally IRVING L. JANIS, *GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES* 174-77 (2d ed. 1983); Fanto, *supra* note 6, at 460-72.

<sup>32</sup> See, e.g., COMMITTEE ON CAPITAL MARKETS REGULATION, *supra* note 16, at xiii.

<sup>33</sup> See U.S. Securities and Exchange Commission, Voluntary Initiative Regarding Allocations of Securities in “Hot” Initial Public Offerings to Corporate Executives and Directors (Apr. 28, 2003), <http://www.sec.gov/news/press/globalvolinit.htm> [hereinafter Voluntary Initiative].

<sup>34</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.) [hereinafter Sarbanes-Oxley].

political officials.<sup>35</sup> Moreover, it would prohibit broker-dealers from selectively penalizing investors (i.e., retail, but not institutional) who “flipped” (i.e., immediately resold) IPO shares,<sup>36</sup> would ban the entry of unpriced orders on the first day of IPO trading (which could add to the IPO frenzy),<sup>37</sup> and would not allow the managing underwriter discretion in selling any returned shares of “hot” IPOs.<sup>38</sup> The Committee also recommended that the issuer’s DSPs be limited to 5% of the offering (so as to restrain “friends and family” abuses in IPOs), that DSP shares be subject to the lock-up, and that more information about these DSPs be disclosed in the IPO prospectus, as well as that there be more disclosure about lock-ups, exceptions to lock-ups, and derivative contracts by the banks to protect individuals whose shares are locked up.<sup>39</sup>

The NASD (the primary SRO for broker-dealers, which has been recently renamed the Financial Industry Regulatory Authority or “FINRA”) took action on many of these recommendations and explained that certain problematic broker-dealer misbehavior was prohibited under its existing rules. Spinning IPO shares to money managers was addressed by NASD Rule 2790, which was promulgated in 2004 and which replaced a longstanding NASD interpretation of its rules addressing similar practices.<sup>40</sup> By contrast, spinning IPO shares to officers and directors of clients would be prohibited by proposed NASD Rule 2712, which has not been finalized.<sup>41</sup> In the meantime, the Global Research Analyst Settlement addressed this kind of spinning (at least until 2008, when it expires).<sup>42</sup> NASD Rule 3060 arguably prohibits the practice as well, since it disallows a broker-dealer or an “associated person” of the broker-dealer from giving anything of value in excess of \$100 to a client for business purposes.<sup>43</sup>

Indeed, proposed NASD Rule 2712 would deal with many of the IPO abuses identified by the NYSE/NASD IPO Advisory Committee. It bans “quid pro quo” arrangements (i.e., brokers allotting IPO shares in return for excessive commissions on other trades), although the practice is arguably covered by NASD Rule 2330(f), which prohibits a broker-dealer

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<sup>35</sup> See NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 2, at 10-11.

<sup>36</sup> See *id.* at 7.

<sup>37</sup> See *id.* at 6.

<sup>38</sup> See *id.* at 7-8.

<sup>39</sup> See *id.* at 13, 16-18. The Committee also offered other recommendations, such as SEC rules be changed to permit broader public access to the broker-dealers’ roadshows (an approach later adopted by the SEC) and that there be more investor education about IPOs. See *id.* at 14-15, 19-20.

<sup>40</sup> See NASD RULE 2790(a)(1); NASD NOTICE TO MEMBERS 03-79, <http://finra.complinet.com/nasd/display/index.html> (online NASD Manual).

<sup>41</sup> NASD RULE 2712(b) (Proposed 2003); SR-NASD-140 (Dec. 9, 2003).

<sup>42</sup> See Voluntary Initiative *supra* note 35.

<sup>43</sup> See NASD RULE 3060(a).

from sharing profits with a customer.<sup>44</sup> It prohibits selective imposition of penalties upon associated persons of broker-dealers if their customers have flipped IPO shares where no penalty bid has been imposed on the broker-dealer itself.<sup>45</sup> “Laddering” was initially addressed in Rule 2712, but this proposal was later dropped due to the industry’s concern about the difficulty of enforcing it.<sup>46</sup> In any event, the practice is likely covered by Rule 101 of SEC Regulation M, which prohibits price manipulation in a securities offering.<sup>47</sup> Moreover, laddering is addressed indirectly insofar as the proposed Rule, following upon the Committee’s recommendation, would ban market orders for one trading day following an IPO.<sup>48</sup> In addition, the proposed Rule addresses the situation where IPO securities are returned to the managing underwriter, who would not be able to allot them to favored clients but would have to sell the securities on the market and return the difference, if any, between a higher market price and the offering price to the issuer.<sup>49</sup>

A potential solution to the bandwagon group effect that magnifies the self-interest of individual IPO participants is to have someone, an outsider, oversee the IPO process, with the understanding that the outsider would be independent enough to prevent him or her from being drawn into the IPO group’s dynamic and would particularly oversee the broker-dealer’s involvement. The outsider, however, would have the necessary authority so that participants could not ignore his or her views. The NYSE/NASD IPO Advisory Committee made a suggestion in line with this approach when it proposed giving the independent directors on the issuer’s board a greater role in the IPO process and pricing.<sup>50</sup> Proposed NASD Rule 2712 would also require the managing underwriter to give the pricing committee of the board of directors (or the entire board in the absence of this committee) information about the results of the bookbuilding and final allocations in the offering.<sup>51</sup> Under the proposed Rule, the managing underwriter would have to notify the board and to make a public announcement about any waiver of a lock-up pertaining to insiders’ sales of shares and to make sure that the lock-up applies to any shares that the issuer directs to insiders in the offering.<sup>52</sup>

I shall have more to say below about this involvement of the IPO issuer’s board of directors in the IPO process. Yet I am skeptical about how

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<sup>44</sup> See NASD RULE 2712(a) (Proposed 2003); NASD RULE 2330(f).

<sup>45</sup> See NASD RULE 2712(d) (Proposed 2003).

<sup>46</sup> See SR-NASD-2003-140 (Dec. 9, 2003), Amendment 1, *available at* <http://www.sec.gov>.

<sup>47</sup> See 17 C.F.R. § 242.101(a) (2007).

<sup>48</sup> NASD RULE 2712(e)(3) (Proposed 2003).

<sup>49</sup> *Id.*

<sup>50</sup> See NYSE/NASD IPO ADVISORY COMMITTEE, *supra* note 2, at 4-5.

<sup>51</sup> NASD RULE 2712(e)(1) (Proposed 2003).

<sup>52</sup> NASD RULE 2712(e)(3) (Proposed 2003).

more involvement of the board in pricing and allocation will actually improve the IPO process, especially given the inadequate performance of independent directors in matters closer to their area of competence, such as corporate governance. Moreover, not only are directors affected by self-interest since they typically receive allocations in DSPs, but they are generally unlikely to have the kind of knowledge to be able to deal effectively with the investment bankers. A related reform is the engagement of an independent underwriter to be involved in IPO pricing.<sup>53</sup> One can also question how effective the use of an independent underwriter will be to counter IPO abuses. Since the “independent” broker-dealer is likely to be engaging in them in its own underwriting, it will not want to have a reputation of being uncooperative as to other banks’ IPOs if it hopes to attract future IPO business, including being a co-manager with other broker-dealers on transactions.

It is important to mention the regulation of research analysts in the IPO reforms, especially since they were held to have had such a large influence upon the retail investors’ purchase of IPO shares in the aftermarket. This is an enormous topic, but it is important for my later discussion. In Sarbanes-Oxley, Congress added Section 15D to the Exchange Act that directed the SEC itself or through the SROs to implement rules addressing research analysts’ conflicts of interest with respect to equity securities.<sup>54</sup> The purpose of this part of the legislation is to separate research analysts from investment bankers, in an attempt to insulate them from the bankers’ pressure. It also added to the SEC and SRO regulation of research analysts that had already occurred by the time of the enactment of the legislation (spurred by the New York Attorney General’s investigation of the analysts). As is well known, the SEC promulgated Regulation AC, which requires, among other things, certification by an analyst as to his or her belief in the research recommendation.<sup>55</sup> Again, regulation of research analysts is indirectly relevant to the IPO abuses, for broker-dealers win IPO mandates partly by promising favorable subsequent coverage by their analysts (and having analysts themselves promise such to obtain the IPO mandate). Moreover, as noted earlier, favorable analyst coverage of the issuer can particularly help insiders for, right before the expiration of the lock-up, the analyst can release a favorable research report on the company (known as a “booster shot”).

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<sup>53</sup> This is similar to the current situation where a qualified independent underwriter is required for pricing when a broker-dealer is underwriting its own securities or those of an affiliate. See NASD RULE 2720.

<sup>54</sup> See Sarbanes-Oxley § 501 (codified as 15 U.S.C. § 78o-6).

<sup>55</sup> See Regulation Analyst Certification, Securities Act Release No. 8193, 68 Fed. Reg. 9482 (Feb. 27, 2003), 17 C.F.R. pt. 242.

Among other things, the relevant SRO rules separate analysts from investment banking and, indeed, from the IPO process in a number of ways. They prohibit an investment banker from supervising a research analyst, determining his or her compensation, retaliating for an analyst's research report or public appearance, and reviewing his or her research report prior to its publication.<sup>56</sup> With respect to the IPO process, the rules prohibit broker-dealers from offering a company favorable research in return for the mandate. They also prohibit research analysts from marketing a transaction (analysts can discuss pricing information with investment bankers after a mandate is received), from soliciting business from an issuer (although analysts can participate in company due diligence after a mandate is received), and from participating in road shows or speaking to investors with company executives and investment bankers (analysts can talk with investors separately and educate the broker-dealer's sales force once the broker-dealer has the mandate, provided that their discussion is "balanced").<sup>57</sup> An analyst's compensation cannot be based upon specific transactions or on evaluations of investment bankers.<sup>58</sup>

In addition, under SRO rules, an investment bank that manages or participates in an offering may not immediately publish a research report, or have an analyst make a public appearance, following the offering date (except for a report that relates to significant news or a significant event about to the company, which would generally trigger a company's Form 8-K filing).<sup>59</sup> There is also a blackout period for analyst research reports and public appearances of analysts (but only pertaining to broker-dealers that managed or co-managed the offering) around the expiration, waiver, or termination of a lock-up of insiders' shares by the broker-dealer (also subject to the significant news or event exception).<sup>60</sup> Research analysts also have restrictions on their personal trading: an analyst is not allowed to purchase securities of private companies in the same line of business as that covered by the analyst; there is a blackout period for purchases or sales of company securities by the analyst around the release of a research report; and the analyst is prohibited from trading against his or her

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<sup>56</sup> See NYSE RULE 472(b); NASD RULE 2711. See also Self-Regulatory Organizations, Exchange Act Release No. 55,072, 72 Fed. Reg. 2058 (Jan. 17, 2007).

<sup>57</sup> See NYSE RULE 472(b)(5), (6); NASD RULE 2711(c).

<sup>58</sup> See NYSE RULE 472(h); NASD RULE 2711(d).

<sup>59</sup> For a manager or co-manager, the cooling off period for a research report and a public appearance by a research analyst is 40 days; for a member of the underwriting syndicate the period is 25 days. See NYSE RULE 472(f)(1)&(3); NASD RULE 2711(f)(1) & (2).

<sup>60</sup> The blackout period is fifteen days before and five after the event. See NYSE RULE 472(f)(4); NASD RULE 2711(f)(4). The NASD would eliminate this period, and the NYSE would reduce it to five days before and after and broaden the exceptions to include earnings announcements. See 72 Fed. Reg. at 2070, 2075.



recommendation in the report.<sup>61</sup> Detailed disclosure about conflicts of interest of analysts and broker-dealers must be placed in research reports.<sup>62</sup>

#### IV. NEED FOR BROKER-DEALER PROFESSIONALISM

My recommendation with respect to the IPO abuses is both general and specific. It is based upon a view that the most significant reform must come from the management and employees of broker-dealers themselves. Certainly, the SEC and the SROs have a significant role in the process, and they have already taken important actions, as described above, to address some IPO abuses. Yet they do not have the resources to oversee the behavior of broker-dealers in IPOs. Moreover, even SEC Commissioners and staff members, as well as SRO regulatory personnel, who are without doubt dedicated people, may not always pursue fundamental reforms vigorously because they suffer from conflicts of interest. Given the constant movement of individuals between the SEC and broker-dealers, these regulators cannot be seen as being unaccommodating to the industry that they regulate and that may be their source of future employment.<sup>63</sup>

My basic point is that the technical reforms skirt around the fundamental problem of dealing with self-interest and, even at times, exacerbate it in a perverse way. Certainly, it makes sense to prohibit spinning, laddering, and kick-backs of IPO proceeds to broker-dealers and to separate research analysts from investment bankers. It is a natural and logical move for regulators and industry members to ban an unfair, abusive practice. It is especially logical when the recommendation comes from, or is acknowledged by, industry insiders, who understand the most flagrant abuses in financial practice. But this represents only the first step in any reform. A good example of the incompleteness of the reforms is the regulation of research analysts in broker-dealers, as discussed above. The research analyst is now walled-off from investment banking and told to be true to his or her ideals of objectivity as to the proper evaluation of companies. In a sense, an analyst is asked to be a professional, rather than a self-interested salesperson. That is, he or she is to base his or her conduct in the securities market upon fidelity to methods of analysis and standards of knowledge and to be honest in his or her actions and language. But the unstated assumption of imposing the wall around the research analyst and

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<sup>61</sup> See NYSE RULE 472(e); NASD RULE 2711(g). These restrictions are subject to detailed exceptions.

<sup>62</sup> See NYSE RULE 472(k); NASD RULE 2711(h). This disclosure can be placed on the broker-dealer's web site, to which it can be referred or hyperlinked in the research report.

<sup>63</sup> This is an old point made in scholarly literature about regulatory agencies such as the SEC. See SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* 22-24 (1981).

elevating his or her standard of conduct is that those outside the wall are not held to the same professional ideals and standards.

In other words, investment bankers are free to act in a self-interested way to seek IPO mandates and to complete transactions. Similarly, the brokers in the sales force who, despite their current professional-sounding name, “financial advisors,” are also not directed to be professionals and are allowed to focus only on selling the broker-dealer’s products and generating commission or fee income. It is as if the brokerage industry actually agreed to make its “public face” (now so widely available over the Internet) professional, but declined to make its most productive employees assume the same status. It is true that, as discussed above, the investment bankers are now prohibited from engaging in some of their former practices, such as spinning IPO shares to company officials. But they have not been asked, as have the research analysts, to act as professionals in all circumstances, which would mean scrupulously avoiding conflicts of interest in their conduct and attempting to be as objective as possible in their advice and recommendations. For example, a relationship banker does not have to certify that an IPO is, in his or her belief, in the best interests of the company, or that the IPO price is, in his or her professional judgment, the highest possible in the market.<sup>64</sup> They have not been asked to reform their fundamental behavior, and therefore other abuses by them are likely to occur even if we cannot anticipate their form now. Indeed, executives of broker-dealers and the investment bankers themselves can even believe that, since the firm has a public professional conscience in the research analysts, and since firms engage in extensive disclosure of conflicts of interest (placed for all to see on the Internet), the bankers and brokers are free to be self-serving in their business conduct.<sup>65</sup>

The problem thus needs a solution beyond the reforms addressing specific IPO abuses. It is the kind of problem that is endemic to any profession, particularly one that takes place in the large, complex institutions that are broker-dealers—the conflict between profits and ideals. Broker-dealers must recognize that, if unaddressed, the abusive behavior of their most productive employees poses a significant risk to them. In financial regulatory terms, the risk here is the “reputational” risk that a broker-dealer (or any financial institution) may incur from its employees’ abusive and exploitative practices. Professor Ingo Walter defines “reputational risk” as losses due to management processes related to the

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<sup>64</sup> Under NASD RULE 2110, a securities professional has only the general mandate to “observe high standards of commercial honor and just and equitable principles of trade.”

<sup>65</sup> A related point has been made by psychologists and organizational theorists when they observe that disclosure of conflicts of interest may actually liberate those making the disclosure to act in a self-serving manner. See Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 3-4 (2005).

following factors: “[r]eputational risk in turn is related to the strategic positioning and execution of the firm, conflicts of interest exploitation, individual professional conduct, compliance and incentive systems, leadership, and the prevailing corporate culture.”<sup>66</sup> He discusses how a firm incurs the risk because misbehavior by the firm’s employees activates and catalyzes social values in prosecutors and regulators, who are spurred into action and who seek to punish the firm for this misbehavior. But these social values that are activated are particularly difficult to identify, and it is also hard to know when they will be triggered. And the broker-dealer always balances this risk against the profitability and the success of the firm. In his view, reputational risk particularly arises from the existence of conflicts of interest in financial conglomerates where cross-selling is encouraged, but where the financial institution’s interests are opposed to those of its clients, or it is faced with the situation of having to favor certain clients over others.<sup>67</sup> For him, these conflicts pose a significant reputational risk as well as extreme compliance costs.<sup>68</sup>

Reputational risk presents very real dangers to broker-dealers and to other financial institutions that depend upon client and customer relationships. From one perspective, Enron’s fall is an example of the loss of reputation, since the company had evolved into a financial institution, and since the unethical and illegal behavior of its employees caused a loss of confidence in Enron among its shareholders and counterparties.<sup>69</sup> Other examples from the past come to mind, such as Salomon Brothers from a scandal involving sales of U.S. government securities, or Drexel Burnham from scandals in the junk bond market.<sup>70</sup> In a bubble environment, or in a period of significant competitive pressures, concern about safeguarding the financial firm from reputational risk may be swept aside as bankers compete for deal flow and for the significant immediate wealth that comes with it.<sup>71</sup> Today, the risk may be even more acute because broker-dealers

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<sup>66</sup> See Ingo Walter, *Reputational Risk and Conflicts of Interest in Banking and Finance: The Evidence So Far* 3-4 (N.Y.U., Leonard N. Stern Sch. of Bus., Dep’t of Econ., Working Paper No. 06-27, 2006), available at <http://ssrn.com/abstract=952682>.

<sup>67</sup> See *id.* at 21 (giving the example of Citigroup’s involvement in WorldCom, where Citigroup favored the company over debt investors who purchased WorldCom debt underwritten by Citigroup).

<sup>68</sup> See *id.* at 24-25 (stating his belief that market discipline can best address reputational risks).

<sup>69</sup> Arthur E. Wilmarth Jr., *Conflicts of Interest and Corporate Governance Failures at Universal Banks During the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom* 10 (Geo. Wash. U. L. Sch. Pub. L. & Legal Stud. Research Paper, Working Paper No. 234, 2007), available at <http://ssrn.com/abstract=952486>.

<sup>70</sup> See generally DANIEL FISCHER, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION (1995) (on junk bond scandals).

<sup>71</sup> See Alexander Ljungquist et al., *Competing for Securities Underwriting Mandates: Banking Relationships and Analyst Recommendations*, 61 J. FIN. 301, 303, 337 (2006)

(and other financial institutions) for the most part are public companies, and thus the loss of reputation can hit them from different sides, as it did with Enron. And behind this risk is the ultimate nightmare of financial regulators—systemic risk—which could well be occasioned by a generalized public flight from the financial industry triggered by the demise of one or two significant institutions.<sup>72</sup>

Since the abusive behavior of investment bankers, leading as it does to reputational risk, runs counter to the long-term well-being of the brokerage industry and of capital raising in general, their training, and that of brokers and other participants in the financial industry and business, has to change. This subject is too large for this essay, for it would involve discussing the decline of professionalism in broker-dealers before the explosion of financing activity in the 1980s.<sup>73</sup> I would only observe that, following the financial and corporate scandals, business school educators became concerned (and some were convinced) that their training of business school students contributed to the scandals.<sup>74</sup> A very interesting example in this regard is Michael C. Jensen, one of the most well-known proponents of agency theory, who now advocates the importance of conduct based upon “integrity” for financial firms and the markets, as opposed to conduct based upon excessive self-interest.<sup>75</sup> He means by this term an organization (among other things) that is “whole, complete, and stable.”<sup>76</sup> He offers as an example of a lack of integrity a company that knows that its stock is overvalued, but issues it anyway in a merger. For him, this transaction produces market instability because, while the present stockholders may be content with the inflated value, the target’s shareholders will later be dissatisfied when they find that the merger consideration is overvalued. In the IPO context, Jensen gives the example of analysts colluding with managers to forecast long-term growth in the firm’s stock, only to have its long-term performance be substandard.<sup>77</sup> For Jensen, this short-term deceptive opportunism makes the system of value

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(contending that the competition from commercial banks in the bubble environment upset the equilibrium in investment banking and led some banks and analysts to sacrifice their reputation).

<sup>72</sup> See LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 177 (2d ed. 2004) (quoting Frederic S. Mishkin, *Securing a safety net against economic free fall*, FIN. TIMES (London), June 6, 2000, at 2).

<sup>73</sup> On this subject, see KNEE, *supra* note 24.

<sup>74</sup> See, e.g., Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACADEMY MGT. LEARNING & EDUCATION 75 (2005).

<sup>75</sup> See Michael C. Jensen, Keynote Address at the meetings of the American Finance Association: *Putting Integrity Into Finance Theory and Practice: A Positive Approach* (Jan. 6, 2006) (Harvard NOM Research Paper No. 06-06 (2006), available at <http://ssrn.com/abstract=876312>).

<sup>76</sup> See *id.* at 5.

<sup>77</sup> See *id.* at 44-46.

creation unstable.<sup>78</sup> Integrity demands that parties work for the *long-term* stability of the organization, the relationship, and the financial system. According to Jensen, (and fellow Harvard Business School professor Rakesh Khurana) business school students, who are future investment bankers, hedge fund managers, and firm executives, need to be trained to understand the importance of these pro-social norms in corporations and in finance, in opposition to the current self-interested focus, in promoting the “integrity” of firms and the financial marketplace.<sup>79</sup>

The financial world cannot wait for a new generation of investment bankers and brokers trained to place importance on integrity in their transactions and business relationships. As an additional pragmatic solution, but one with a broader, less targeted purpose than many of the reforms previously discussed, I would suggest using in the IPO area a reform that financial companies adopted (or had imposed upon them through settlements) after their involvement in corporate or financial scandals: the formation of a senior transaction/client relationship review committee.<sup>80</sup> The purpose of this committee would be to review transactions, such as IPOs, from the perspective of the reputation of the financial institution itself, and of the long-term sustainability of the institution and the financial industry, not from the self-interested positions of the investment banker deal teams, or even the interest of the corporate finance department or the yearly earnings of the financial institution. Ideally, this committee, composed of senior executives from business divisions, internal auditing, legal, and compliance functions, would try to ensure that the firm does not enter into transactions or engage in practices that could bring significant legal liability upon the institution and/or threaten its reputation.<sup>81</sup> One would hope that this committee, looking into the IPO area, would have questioned and prohibited the massive IPO underpricing that even reputable firms, which had formerly eschewed such practices, fell into, as well as the related allocation abuses, such as sending hot IPO shares to potential clients, and the disjunction between private and public views of their analysts. All of these practices demonstrated a lack of professionalism and integrity by the financial institution. If, moreover, the

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<sup>78</sup> See *id.* at 4 (in his view, over time and over the long run, the lack of integrity will make the system unstable); see also Werner H. Erhard et al., *Integrity: A Positive Model that Incorporates the Normative Phenomena of Morality, Ethics, and Legality* 52-53 (Harvard NOM Research Paper No. 06-11, revised July 29, 2007).

<sup>79</sup> See Jensen, *supra* note 75, at 19.

<sup>80</sup> I have discussed this kind of committee in another context. See James A. Fanto, *Subtle Hazards Revisited: The Corruption of a Financial Holding Company by a Corporate Client's Inner Circle*, 70 BROOK. L. REV. 7 (2004).

<sup>81</sup> For the workings of the committee, see Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 72 Fed. Reg. 1372, 1374 (Jan. 11, 2007).

bulge bracket firms prohibit certain practices, is it really likely that their competitive position will be undercut by unscrupulous upstarts in the financial industry?

The committee should also take the long view of the broker-dealer's role in the U.S. capital markets and in the markets themselves, understanding that, if the markets are undermined by abusive IPO practices, financial institutions themselves will likely not survive. To use another analogy from global warming, this is the kind of long-term view that energy and other companies may finally be taking, as opposed to their understandable, but short-term, resistance to modification of the status quo. Moreover, the professionalism, which has as its goal the promotion of behavior that is not single-mindedly self-interested, can be developed and supported by this committee so that it is adopted by all broker-dealer employees, not simply research analysts. The committee should also be regularly in contact with securities regulators, like the SEC and the NASD, who can offer their views on market practices and market problems from a perspective that is based upon the long-term stability of financial institutions and the financial system. In order to make the committee accountable, it should be required to provide an annual report of its activities to the broker-dealer's shareholders and attach it to the broker-dealer's annual proxy statement.

The obvious question is how successful can this committee be, given the competitive pressures placed upon it. Will it be only window dressing, or a place for bureaucratic wars involving divisions within the broker-dealer? These possibilities stem from the tremendous pressure due to the demands of profitability since the investment banks are public firms. Profitability requires retaining top bankers and brokers, who these days are always ready, with the slightest provocation, to move outside the banks to competitors or the unregulated financial institutions, like hedge funds and private equity firms.<sup>82</sup> In addition, profitability may demand more trading and proprietary profits, which means that the investment banks engage in activities raising more potential conflicts with clients. An even more difficult question is determining which ethical, moral or even political economic foundation the bankers in the committee should base their work upon. Professor Jensen is obviously struggling with this issue by offering his notion of "integrity," because he is attempting to find a value that is neutral (e.g., openness, commitment, willingness to correct misbehavior) and is thus widely acceptable, without provoking debates about the definition of ethically appropriate behavior.

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<sup>82</sup> A good example is what occurred at Citigroup. The head of wealth management, Todd Thomson, allegedly ran up excessive expenses. The then CEO Charles Prince told him to restrain his expenses, but was ignored. Thomson was released from the firm and will probably end up managing money privately. See Monica Langley et al., *In Citigroup Ouster, A Battle Over Expenses*, WALL ST. J., Jan. 24, 2007, at A1.

## V. CONCLUSION

My contention in this essay has been straightforward. The specific IPO abuses that surfaced during the market bubble in the late 1990s involved the active participation of broker-dealers. These financial firms orchestrated the abuses and enlisted the aid or acquiescence of other participants in the process, chiefly the executives and major shareholders of the IPO firms, as well as favored institutional investors. Pushed by the New York Attorney General and ultimately Congress, the SEC and the SROs have put an end to the abuses through prosecution and regulation, even if the regulation has not entirely been finalized in SRO rules. Thus, the IPO abuses are something of ancient history, although, as explained above, a debate about the advantages of the U.S. system of price determination—bookbuilding—as opposed to other alternatives, is ongoing.

My point is that the IPO abuses indicate a larger problem in broker-dealers, which could be labeled as an excessive focus upon self-interest within the firms, and an accompanying characteristic: the decline in professionalism among broker-dealers. As discussed above, the IPO reforms, while addressing specific abuses, may have exacerbated this underlying problem because, although they reinforced the professionalism of the research analyst, they did not do the same for the investment bankers and the brokers. This shortcoming is understandable, since this kind of professional reform would have to be wide-ranging and reach within the business schools that produce the future broker-dealer professionals. After pointing to work on such reform, I offer a short-term solution for broker-dealers, which is for them to institute a transaction/relationship review committee that has, as one of its purposes, the goal to guard against IPO practices that would threaten the broker-dealer's reputation, and that is designed to enhance the firm's professionalism. This is admittedly only a stopgap measure. As long as broker-dealers continue to play a role in the IPO process, only a renewed professionalism among them will likely curtail future abuses.

